

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

STRATEGY FOR MOLDOVA

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EXECUTIVE SUMMARY

Moldova is committed to and has made progress in applying the principles of multi-party democracy and pluralism in accordance with Article 1 of the Agreement Establishing the Bank.

The record on democratic and market reform over the past strategy period has been uneven. National elections in March 2005 generally conformed to international standards for democratic elections according to the Organisation for Security and Co-operation in Europe (OSCE). Nevertheless, they fell short in some areas that are central to a genuinely competitive election process, such as media access. The ruling Communist Party of Moldova (CPM), which once again won a majority of seats in the recent parliamentary elections, reinforced its commitment to European integration in the course of the campaign. This is a welcome development, as it entails political and economic policy adjustments that, if implemented successfully, would be fully consistent with the Bank's Article 1 mandate. Moreover, political developments in neighbouring countries Ukraine and Romania reinforce these policy shifts. On the issue of the breakaway territory of Transnistria, a recently proposed Ukrainian plan has gained the conditional support of the Moldovan parliament and the endorsement of the OSCE Parliamentary Assembly; however, full realisation of the plan will require a number of difficult intermediate steps and an unwavering commitment from all the parties to the five-party talks on a resolution.

The macroeconomic performance of the Moldovan economy over the past two years has been good. The gross domestic product (GDP) grew in real terms by 6.3 and 7.3 per cent in 2003 and 2004, respectively. High levels of worker remittances and fast growth in the region were the main drivers of economic growth. Fast domestic credit growth and strong foreign currency inflows have exerted significant pressure on domestic prices and inflation has once again surged to double digits. The sharp currency appreciation in 2004 has had a mild effect on external competitiveness as exports continue to grow supported by strong economic growth in the region. Fiscal performance has improved pursuant to strong indirect tax receipts. The government has pursued a prudent fiscal policy managing to sustain consolidated budget surpluses in both 2003 and 2004, thus providing a stronger base for debt servicing. Social indicators have also improved, mostly due to the remittance financed safety net. However, Moldovan indicators still lag behind the regional averages. In 2004 Moldova's external debt burden was considerably reduced to 74 per cent of GDP and its debt service improved. Foreign direct investment (FDI) flows increased in 2004 following poor inflows in 2003, but remain significantly below the economy's needs. The difficult business climate, government interference and the slow pace of privatisation all hampered the inflow of high quality foreign investment. The banking sector is growing in line with the economy but weaknesses related to corporate governance, supervision and lack of transparency in banking ownership need to be addressed to ensure the sector's potential is realised. Corruption remains a serious problem, undermining the administrative and legal efforts to improve the business environment.

Moldova has made some progress in reform over the last strategy period. Formal trade barriers and administrative hurdles with respect to business registration, licensing and tax administration were reduced. The "Guillotine Law" adopted in February 2005 is expected to lead to further cuts of red tape. Some progress was also made in the telecom

sector, which was fully liberalised in 2004. Despite these improvements important weaknesses remain. Privatisation has lingered in the past two years and privatisations in key areas such as energy and wineries were either postponed or failed to attract sufficient interest. Reform in the energy sector and municipal infrastructure sector advanced slowly or not at all. Although commercial lending volumes have continued to grow, access to long-term finance for investment projects remains a significant barrier for entrepreneurs. While in the short run growth is likely to continue, long term prosperity will depend on renewed efforts to implement structural reforms, strengthen institutional capacity building and improve the investment climate.

Following its early transition achievements, Moldova should implement a medium-term agenda of deeper institutional and structural reforms to consolidate the conditions for long-term growth and poverty alleviation. In particular Moldova will need to address the following transition challenges:

- *Establishing fair competition and improving the investment climate.* Moldova needs to reduce government interference, strengthen its regulatory and competition authorities, streamline its legal framework (particularly with respect to registration, licensing and operation of businesses), remove informal and administrative barriers to business and step-up its fight against corruption.
- *Supporting economic diversification.* Moldova's overwhelming dependence on agriculture and food industry as well as its excessive reliance on CIS markets (in particular Russia) increase Moldova's vulnerability to adverse shocks. In order to achieve long-term sustainable growth, Moldova needs to decrease its dependence on the agricultural sector and diversify its export markets.
- *Redressing the balance between the capital city and the regions.* Regionally balanced economic development throughout the country will require increased investment in regional infrastructure and adequate support for the emergence of MSEs and SMEs in rural areas.
- *Advancing energy and municipal sector reform.* Further regulatory reform is required to promote fair competition and efficiency, the remaining state-owned generation assets and distribution companies should be privatised and the district heating systems need restructuring and modernisation. The municipal infrastructure sector requires commercialisation, tariff reform and substantial restructuring.
- *Ensuring debt sustainability.* Prudent fiscal policy and tight monetary policy will be required to service the large stock of external debt and ensure macroeconomic stability.

Moldova's Economic Growth and Poverty Reduction Strategy Paper and the EU-Moldova Action Plan, adopted by the government respectively in May 2004 and February 2005, provide an ambitious road map to meet these challenges. The Bank will - within the limits of its mandate - assist Moldova in the implementation of this road map. In the context of the Early Transition Countries (ETC) initiative the Bank will draw on the additional instruments and resources available to it. In particular, the Bank will pursue the following operational objectives:

- *Financial Institutions.* The Bank will provide SME and MSE credit lines and continue to implement its Trade Facilitation Programme (TFP) as well as its Medium-sized Co-financing Facility (MCFF) with local banks to overcome lending

constraints caused by single borrower exposure limits and portfolio concentration. The Bank will seek to extend its cooperation to new partner banks and will assist in the development and promotion of new financial instruments such as mortgage financing or leasing. On the equity side, the Bank may assist in the privatisation of Banca de Economii and consider investment in leasing companies and mortgage providers. The Bank will further enhance its support for the development of micro-finance. In order to support the development of Moldova's regions, the Bank will include a regional component in its micro-finance programmes. The Bank will explore opportunities to support, through both technical assistance and investment, the emergence of the non-banking financial sector.

- *Private Enterprise.* The Bank will continue to pursue investment opportunities in all enterprise sectors including, without limitation, the food processing, manufacturing, retail and property sectors. Larger, well performing, companies will be provided with direct financing through ETC instruments such as the MCFF and the Direct Investment Facility (DIF). The Bank will facilitate FDI either by investing alongside foreign strategic investors or by assisting the development of local companies which in due course may attract foreign investment. Working capital will be provided to agribusinesses, upon the establishment of a warehouse receipt system. The Bank will continue to provide non-financial support to private enterprises through its Turn Around Management (TAM) and Business Advisory Services (BAS) programmes.
- *Infrastructure.* Given Moldova's sovereign debt capacity constraints, the Bank will primarily seek to support private infrastructure investments.

The Bank will underpin the aforementioned operational objectives by an ongoing policy dialogue on investment climate, enterprise restructuring and rule of law in consultation with other IFIs and bilateral donors. The Bank will ensure that all operations in Moldova are subject to the Bank's Environmental Policies and Procedures. In the context of the ETC initiative, the Bank will seek increased donor grant financing to fund project preparation and implementation, support legal transition work, institution building and policy dialogue and leverage the Bank's financial support to key sectors.

LIST OF ABBREVIATIONS

ANRE	National Energy Regulatory Agency
ANRTI	National Regulatory Agency for Telecommunications and Information Technologies
BAS	Business Advisory Services
BSTDB	Black Sea Trade Development Bank
CAS	Country Assistance Strategy
CDDP	Christian Democratic People's Party
CIS	Commonwealth of Independent States
CPM	Communist Party of Moldova
DEG	Deutsche Investitions- und Entwicklungsgesellschaft mbH
DFID	Department for International Development
DIF	Direct Investment Facility
DMB	Democratic Moldova Bloc
DSSM	Declaration of Stability and Security for the Republic of Moldova
EGPRSP	Moldova's Economic Growth and Poverty Reduction Strategy Paper
ENP	European Neighbourhood Policy
ETC	Early Transition Countries
EU	European Union
Euro or €	Euro, the currency of the member states of the EU participating in the European Monetary Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HACCP	Hazard Awareness And Crucial Control Points
ICT	Information and Communication Technology
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institution
ILO	International Labour Organisation
IOM	International Organisation for Migration
IOSCO	International Organisation of Securities Commissions
ISO	International Organization for Standardization
Leu or MDL	Moldovan Leu, the currency of Moldova
MCFF	Medium-sized Co-financing Facility
MIGA	Multilateral Investment Guarantee Agency
MNCS	National Commission for Securities of Moldova
MSEs	Micro and Small-sized Enterprises
NBM	National Bank of Moldova
OSCE	Organisation for Security and Co-operation
PSP	Private Sector Participation
RFC	Rural Finance Corporation
SAC	Structural Adjustment Credit
SDC	Swiss Development Cooperation
SDR	Special Drawing Rights
SECO	Swiss State Secretariat for Economic Affairs
SIDA	Swedish International Development Cooperation Agency

SMEs	Small and Medium-sized Enterprises
SROs	Self-regulatory organisations
TACIS	Technical Aid to CIS
TAM	Turn Around Management
TFP	Trade Facilitation Programme
UNDP	United Nations Development Programme
US	United States of America
USAID	United States Agency for International Development
USD or \$	United States Dollars, the currency of the United States of America
USSR	Union of Soviet Socialist Republics
VAT	Value Added Tax
WB	World Bank
WTO	World Trade Organisation

COUNTRY STRATEGY

1. The Bank's Portfolio

1.1 Overview of Bank Activities to Date

As of June 2005 the Bank has signed 36 projects for a cumulative business volume of €177.7 million of which 83 per cent has been disbursed and €70 million are operating assets. The average project size (excluding sovereign projects) is €2.9 million, highlighting the relevance of the Early Transition Countries (ETC) initiative for Moldova.

The infrastructure sector (transport, municipal and energy) historically dominates the Bank's portfolio, representing 44 per cent of total assets. However, Moldova's weak sovereign debt capacity combined with a weak regulatory framework and a flagging privatisation process, have prevented further infrastructure investments. Since November 2001, the Bank has exclusively invested in the banking and agribusiness sectors which represent respectively 35 per cent and 21 per cent of the Bank's portfolio. During the period covered by the previous country strategy, nine new projects were signed in these sectors for a total amount of €20.2 million. For a more detailed overview of the Bank's projects, please refer to Annex 1.

Table 1: Commitments and Net Portfolio as of June 2005

Sector	COMMITMENTS (€million)					NET PORTFOLIO (€million)		
	No. of Projects	Total Project Cost	EBRD Funding	EBRD % of Total	Disbursed	No. of Projects	Portfolio	% of Portfolio
Financial Institutions	22	79.2	62.1	35%	45.9	17	27.0	31%
Infrastructure	8	152.1	77.8	44%	64.4	7	50.6	59%
<i>Energy</i>	3	65.0	33.9	19%	28.6	3	29.8	35%
<i>Water and Sewage</i>	1	31.7	17.1	10%	17.1	1	12.2	14%
<i>Transport</i>	3	54.2	25.9	15%	17.9	3	8.6	10%
<i>Telecommunications</i>	1	1.3	0.8	0%	0.8	0	0.0	0%
Private Enterprise	6	66.6	37.8	21%	37.6	4	8.4	10%
<i>Agribusiness</i>	5	65.8	37.4	21%	37.4	3	8.0	9%
<i>General Industry</i>	1	0.8	0.4	0%	0.2	1	0.4	0%
Country Total	36	298.0	177.7	100%	147.9	28	86.0	100%

1.2 Implementation of the Previous Country Strategy

The Bank's 2003 country strategy aimed to (i) strengthen the banking sector and financial intermediation, (ii) encourage private sector development by providing direct and indirect financing as well as advisory services to Small and Medium Sized Enterprises (SMEs) and Micro and Small Sized Enterprises (MSEs), (iii) support private sector investment in key infrastructure subject to a suitable operational and regulatory environment, (iv) address the problems affecting the Bank's portfolio and (v) pursue with the government a policy dialogue on the investment climate.

During the previous strategy period, the Bank was the main provider of long-term financing to the Moldovan banking sector and extended its cooperation to one new bank, increasing the total number of partner banks to five. Among others, the Bank developed a pilot medium-sized co-financing facility (MCFF) pursuant to which two sub-projects in the agribusiness sector and one sub-project in the metal industry have been financed to date. Additionally, the Bank extended its trade facilitation programme (TFP) to two new banks.

Because Moldova's economy is essentially dominated by SMEs and MSEs, direct financing opportunities are rare. During the strategy period, the Bank provided one direct loan in the form of a working capital facility to an agro-processing company. Twelve companies benefited from the Turn Around Management (TAM) programme. Towards the end of the strategy period, the Bank approved a Business Advisory Services (BAS) programme for Moldova which will be implemented during the next strategy period.

No new private sector investments occurred in the infrastructure sector in the last two years, in part due to the government's reluctance to actively pursue privatisation in the energy and telecom sectors.

Throughout the strategy period the Bank continued to address the long lasting problems affecting its portfolio. The Bank successfully restructured the Giurgiulesti Oil Terminal project. As a result of the restructuring, the unfinished oil terminal has been transferred to Azertrans, a Moldovan subsidiary of the Azpetrol Group and Moldova has been released from its obligations under the State Performance Guarantee Agreement. Furthermore, Azpetrol has signed a \$250 million investment agreement with the Moldovan government, comprising, among other steps, the completion of the oil terminal. The Bank also restructured the Wine Export Promotion and Glass Container Company Project resulting in a new financing package provided by the Bank and a local bank to Glass Container Company and releasing Moldova from its sovereign obligations to the Bank. In contrast, two other sovereign guaranteed projects, both involving technically bankrupt state enterprises, continue to present payment problems despite repeated interventions by the Bank both at municipal and national level.

The Bank's policy dialogue with the government on the investment climate produced some modest results. One positive development has been the settlement of protracted disputes with Lafarge, the French cement producer. Moldova also took an important step towards cutting red tape and bureaucratic obstacles through the adoption of the "Guillotine Law" in February 2005. The Bank assisted the government in drafting a leasing law, adopted by Parliament in April 2005, and in developing the residential mortgage sector. However, the Government's inability to genuinely embrace market principles have meant that the Bank's efforts to tackle broader issues such as state intervention, the independence of regulators or tariff methodology have so far failed.

1.3 Transition Impact of the Bank's Portfolio and Lessons Learned

1.3.1 Quality of Portfolio

The current net portfolio stands at €86 million of which €70 million are operating assets. Impaired assets account for 12 per cent of total operating assets.

The overall portfolio risk rating is 7.1, reflecting a vulnerable portfolio in a difficult environment. Of six sovereign projects, three are in a precarious position. The Chisinau Energy Efficiency Project involves a technically bankrupt municipal company which relies on VAT reimbursements to manage repayments. Repayments for the Chisinau Water Services Rehabilitation Project were subject to lengthy delays. The Wine Export Promotion and the Glass Container Company Project was partially restructured in 2000. Although it only managed sporadic repayments with delays of up to 186 days, it did so without Government support. The project was restructured for a second time in June 2005. Private sector operations continue to perform well although the Bank's equity investments will require careful monitoring.

1.3.2 Mobilisation of Co-financing

Co-financing is at an early stage in Moldova, with the Bank and other IFIs as the main sources of long-term funds. To date the Bank has mobilised in total €120 million in commercial co-financing from sponsors and co-financiers for a mobilisation ratio of 68 per cent. However, since the bulk of the Bank's projects during the previous strategy period consisted of SME credit-lines, the commercial co-financing raised over the period was modest (€6 million).

1.3.3 Transition Impact and Lessons Learned

The Bank's transition impact was most noticeable in the financial and private enterprise sectors. The MCFE provides a good example of how the Bank advances transition in the financial sector. The facility, which is supported by credit advisory technical assistance financed by the ETC multi-donor fund, enables successful local banks to overcome lending constraints caused by single borrower exposure limits and portfolio concentration. The Bank also promoted transition in the financial sector through two technical assistance projects designed to develop the leasing and residential mortgage markets.

The Bank's micro-finance programme through its network of local branches has a substantial transition impact in rural Moldova by sustaining the development of MSEs thereby creating local employment and lessening urban and cross-border migration. With respect to SMEs the Bank's transition impact often starts well before any financing is extended for instance by assisting SMEs to reform their corporate structure and accounting systems to meet the Bank's standards for corporate governance and transparency. Although not specifically geared to project preparation, the Bank's TAM programme plays a critical role in enabling local SMEs to attract financing either from the Bank or a local bank.

The Bank's transition impact was less significant in the infrastructure sector. Although some progress has been made with respect to the unbundling and privatisation of the energy sector through Union Fenosa's purchase of three electricity distribution companies, the sector remains inherently non-transparent and marked by political interference in the regulatory process. In the municipal sector (confined to the capital Chisinau) the Bank's transition impact was hampered by the municipality's failure to implement a full cost-recovery-based-tariff reform.

In sectors with a weak regulatory framework, which are strategic or where substantial reforms are required, the project approach has limitations. Instead the sector should be

assessed as a whole, vested interests should be identified up-front and the Government's commitment to market reform should be carefully appraised. The Bank's experience shows that transactions which require the involvement of third parties outside the control of the contracting party (such as the adoption of a law by Parliament or a resolution by a municipal council) cannot be covenanted effectively. Sectoral and regulatory objectives which are likely to trigger substantial resistance from vested interest groups can only be achieved when there is a clear political commitment at the highest levels. In order to be successful, projects of this nature require a policy dialogue which should be ongoing, structured and closely coordinated with other international financial institutions (IFIs) and the donor community.

1.4 Portfolio Ratio

During the strategy period the percentage of investments of private sector projects increased from 53 per cent to 59 per cent of the Bank's portfolio, reflecting the absence of any new public sector projects during the period. This trend is expected to continue as Moldova's sovereign debt capacity is restricted and no new public sector projects are currently in the pipeline.

2. Operational Environment

2.1 The General Reform Environment

2.1.1 Political Developments

The Communist Party of Moldova (CPM) retained its parliamentary majority in elections held in March 2005 and Vladimir Voronin was re-elected by the Parliament to a second term as president. The OSCE concluded that the parliamentary election "generally complied with most OSCE and Council of Europe commitments" but fell short in some areas that are central to a genuinely competitive election process, such as media access and the provision of equal campaign conditions. "Restrictive regulations on the campaign and media made it difficult for voters to get basic information about the contestants", the head of the OSCE election mission commented in a press release. Although the CPM still dominates the legislature with a total of 56 seats out of 101, the opposition also fared well – the Democratic Moldova Bloc (DMB), a loose grouping of centrist parties, did better than expected with 34 seats, and the centre-right Christian Democratic People's Party (CDDP) won 11 seats. Those were the only three parties that crossed the rather high threshold for parliamentary representation (6 per cent for individual parties, 9 per cent for coalitions of two parties, and 12 per cent for coalitions of three or more parties). It is an outcome that could strengthen political checks and balances and appears to reflect the will of the people.

The CPM has been drifting toward the political centre in the past year and has generally adopted a more pro-European stance. The leadership has begun to transform the CPM ideologically into a European-style leftist party. On Transnistria, the presidential administration has put forward a Declaration of Stability and Security for the Republic of Moldova (DSSM) that calls for the removal of Russian troops from the breakaway territory and invited the US and the EU to participate in the five-party negotiating framework as observers. Moldova welcomed the appointment by the European Council

of a Special Representative for Moldova, Ambassador Jacobovits de Szeged. The Ukrainian authorities have put forward a new settlement proposal for Transnistria, which is under consideration. The Moldovan Parliament endorsed the plan in June 2005. More broadly, Moldova clearly expressed its intention of pursuing closer integration in European structures. European integration, a popular issue with voters, was a key theme of the CPM during the election campaign. Just prior to the election, Chisinau and Brussels reached agreement on an EU-Moldova Action Plan in the framework of the European Neighbourhood Policy. These policy shifts are welcome news, but it will be important to build a track record of effective implementation in order to put to rest the questions raised by several years of inconsistent application of principles of good governance. For a more detailed political assessment, please refer to Annex 2.

2.1.2 Social and Labour Conditions

Moldova's strong economic growth since 2000 has alleviated poverty. Nevertheless, Moldova remains the poorest country in Europe and long-term growth is required to eradicate poverty. According to the 2004 World Bank Poverty Assessment Report (Report No. 28024-MD), even if Moldova's economy grows at 8 per cent per year, over one in five Moldovans would still be in poverty in 2007. In Moldova poverty is closely correlated with location and education levels. The risk of poverty is highest in small towns where the safety net provided by subsistence farming is absent and employment is scarce. People in rural areas fare better mainly because they can live off the land. Residents of Chisinau and Balti are the least likely to be poor due to better employment opportunities and higher wages. A substantial part of the population (25 per cent) has remained poor throughout the recession and recovery. This group is disproportionately represented by households headed by individuals who lack higher education. The poverty risk is even higher in households where the head is engaged in agriculture, especially as a hired worker. On the other hand, households headed by individuals with higher levels of education have benefited from improved employment opportunities and are less vulnerable to poverty.

Public health care expenditure as a share of GDP (4 per cent) compares favourably to other countries but remains below the levels prior to the 1997 Russian crisis. On the other hand, household out-of-pocket spending on health care has doubled from 1997 to 2002 and informal payments are common. As a result access to health care services is becoming increasingly unequal. The poor account for only 20 per cent of hospital visits and one third of ambulatory care visits. Infant mortality decreased from 21.2 per 1,000 live births in 1996 to 16.4 in 2002 but is still higher than the Central and Southern European average (10.5 per 1,000 live births). Moldova's strong agricultural base has kept severe under-nutrition at bay but falling incomes have resulted in serious micro-nutrient deficiency.

Over the last five years, participation in primary schools remained stable while enrolment in secondary schools and university increased. The quality of education improved but several challenges remain. Grade 6 tests show that many students still score poorly on basic literacy and numeracy skills. Schools lack basic resources and absenteeism is a problem. Although compulsory education is officially free, the cost per student is high, about a third of the per capita consumption of a household at the poverty line.

Employment has declined by 36 per cent since 1991. Despite signs of improvements since 1999, the Moldovan labour market remains depressed. Although real wages have increased by an average of 17 per cent per year over the past four years and unemployment has fallen to 8 per cent according to official statistics, productivity is still very low. The agricultural sector accounts for almost half of all employment but represents less than a third of all paid jobs. It also accounts for over three-quarters of all part-time work and provides the largest share of informal employment. Job creation does not compensate for job destruction and is mainly confined to Chisinau, further accentuating the regional imbalance between the capital and the rest of the country. As a result, a large number of Moldovans seek employment abroad and are vulnerable to trafficking. The 2005 Moldova Remittance Study commissioned by the International Organisation for Migration (IOM) estimates Moldova's migrant contingent to be well over half a million people.

Moldova is a member of the International Labour Organisation (ILO) and has ratified all eight core conventions (including ILO Convention 182 on Child Labour and the International Programme on the Elimination of Child Labour (IPEC)). Notwithstanding this, child labour and human trafficking remain a problem. Street children, children in institutions and Roma are at risk of social exclusion and discrimination.

2.1.3 Legal Reform

Over the years, Moldova has carried out extensive reforms of its commercial and financial legal framework and has managed to put in place a comprehensive legislative base for the transition to a market economy. However, an analysis of key commercial laws that directly contribute to creating a favourable investment climate in Moldova (such as secured transactions and bankruptcy laws) shows that even relatively good laws still suffer from serious implementation problems. Contract enforcement is worse than average for transition countries. Furthermore, Moldova needs to improve its judiciary. Additionally, administrative barriers are a major constraint in the investment climate. Going forward, Moldova should continue to bring its commercial laws in line with international standards and make those laws fully effective, particularly by strengthening the court system, tackling corruption and implementing other measures to strengthen the rule of law. By endorsing the EU-Moldova Action Plan in the framework of the European Neighbourhood Policy in February 2005, Moldova has undertaken important commitments in all these areas. For the Bank's assessment of selected commercial laws, please refer to Annex 3.

2.1.4 Environmental Issues

According to the 2000 Environmental Performance Review Report by the United Nations Economic Council for Europe (UNECE) some environmental quality improvements were achieved. Nevertheless, according to Moldova's Economic Growth and Poverty Reduction Strategy Paper (EGPRSP), pollution of surface and underground water, urban air pollution, soil contamination and erosion, deforestation, failure to protect biodiversity and waste management still remain key environmental concerns. The EGPRSP identifies the conservation of natural resources on which the population relies for their livelihood, and in particular the improvement of air and water quality, as a critical policy issue. There is also a need for institutional capacity building and public participation to support the implementation of the UNECE Convention on Access to

Information, Public Participation in Decision-making and Access to Justice in Environmental Matters (known as the Aarhus Convention). Moldova's intention to harmonize its legislation with that of the EU will require revisions to its 1993 Framework Law on Environmental Protection as well as further legislation in key environmental sectors (water quality, waste management, air quality, industrial pollution and wild flora).

The Bank has a three-prong approach to supporting environmentally sound and sustainable development in Moldova. Firstly, the Bank ensures that its local partner banks implement environmental due diligence procedures and thus support environmentally sound projects. Secondly, the Bank ensures that new stand-alone projects comply with the Bank's Environmental Procedures and Public Information Policy and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during due diligence. Thirdly, the Bank implements ad hoc environmental projects to address specific concerns. For more information on the Bank's environmental approach, please refer to Annex 4.

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic Conditions for Bank Operations

Moldova's overall macroeconomic performance has further improved since the last country strategy. The economy has been growing at an average rate of 7 per cent since 2000 and the Ministry of Economy's outlook for 2005 is about 7 per cent. However, in the medium term this rate of economic expansion is unsustainable without deeper structural reforms, including further improvements in the investment climate and privatisations in key areas such as energy, telecom and winery.

Following a period of steady disinflation, a surge in inflation was recorded in 2003, with an end-period inflation of 15.8 per cent and a subsequent fall to 12.5 per cent in 2004. The National Bank of Moldova (NBM) provided a MDL 594 million loan to the Government for servicing the external debt in 2004, somewhat undermining the stated tight monetary policy goals. The exchange rate of the Leu against the Dollar followed its managed depreciation in 2003, with an annual average exchange rate of 13.94 MDL/\$, but appreciated steeply in early 2004, due to the excess of foreign currency in the market generated by increasing flows of remittances. A peak exchange rate of 11.78 MDL/\$ was reached in May 2004, after which the currency resumed its trend of nominal depreciation towards 12.46 MDL/\$ at the end of 2004. In the absence of structural reforms the supply response was weak and the nominal appreciation translated into a marked real exchange rate appreciation, 24 per cent against the Dollar and 13 per cent against the Euro, with negative consequences for the trade balance, most notably through a surge in imports. The trade deficit has surged to 31.8 per cent of GDP in 2003 and to 29.2 per cent in 2004 from an average 22 per cent earlier in the decade. The current account deficit was 6.68 per cent of GDP in 2003 and 4.4 per cent in 2004, and is expected to stabilise at around 4 to 6 per cent of GDP over the next few years. The flow of remittances transferred by Moldovan citizens working abroad has increased substantially over the past two years. Estimated to be in excess of €500 million in 2004, remittances now play a crucial part in financing the current account.

Fiscal policy has tightened significantly in the past two years. The consolidated national budget had surpluses of 1.1 per cent in 2003 and 0.4 per cent in 2004. These surpluses resulted from better than anticipated revenue performance and prudent spending. Due to the weak supply response in the economy, much of the remittance-financed consumption has fuelled imports, providing increased indirect tax revenues (mainly VAT and excise duties). Moderate social spending and low public investment have kept expenditures in check. For 2005 the Government plans a slight fiscal policy loosening, with a projected deficit of 0.7 per cent of GDP for the consolidated budget, based on a growth assumption of 6 per cent. The Medium Term Expenditure Framework provides for smaller deficits in 2006 and 2007.

Debt rescheduling and the appreciation of the Leu have considerably reduced the external debt burden, but debt sustainability remains one of the country's main macroeconomic challenges. At the end of 2004, Moldova's external debt stock stood at \$1.924 billion (€1.415 billion), or 74 per cent of GDP. The public and publicly guaranteed debt has declined in the course of 2004 with an end-year stock of \$884 million, down from \$1.01 billion in 2003 and \$988 million in 2002. Private debt has steadily increased from \$826 million in 2002 to \$1.04 billion in 2004. Liquidity problems may persist in the short term and the authorities need to tackle the problem of outstanding arrears and their continued accumulation. Following the Eurobond restructuring in late 2002, Moldova continued to restructure its external debt in 2004. Moldova concluded rescheduling agreements with Turkey (\$8.3 million) and Romania (\$9.4 million) and prepaid at a discount its \$114.5 million gas debt to Gazprom and its \$10.2 million debt to Hewlett-Packard. Public and publicly guaranteed debt servicing has improved in 2004. Although arrears have been considerably reduced, the country was still in arrears of approximately \$37 million at the end of the first quarter of 2005. A new IMF programme is a condition for restructuring of Moldova's Paris Club debt worth more than \$200 million. This remains one of the major challenges in the strategy period. For selected economic indicators, please also refer to Annex 5.

2.2.2 Transition Successes and Transition Challenges

Progress in Transition

Moldova made modest progress in structural reforms during the previous strategy period. Moldova joined the World Trade Organisation (WTO) in 2001 but this has not yet led to the desired boost and diversification in exports. The structure of international trade remains largely unchanged. Exports primarily consist of agricultural products, which account for about 53 per cent of total exports. CIS markets absorb just over 50 per cent of exports, down from about 60 per cent two years ago, whereas 43 per cent of imports come from CIS countries. Trade is still hampered by a variety of formal and informal trade restrictions imposed either by importing countries (e.g. agricultural products to the EU) or by Moldova itself (e.g. export restrictions on cereals, sunflower seeds and scrap metal). The transparency of import–export operations is also hindered by the situation in Transnistria, where trade is conducted outside the control of the Moldovan authorities.

Privatisation has progressed slowly in the past two years. The sales of important enterprises in the agribusiness, power and telecoms sectors have been deferred. Three large wineries were however privatised with the help of a financial advisor. The sale of the two remaining state owned power distribution companies was postponed partly due

to the lack of interested strategic investors. Moldova's inability to attract strategic investors is due to the small size of its economy as well as its weak investment climate.

The investment climate has somewhat improved over the past two years but significant weaknesses remain. Formal trade barriers and administrative hurdles with respect to business registration, licensing and tax administration were reduced. Further cuts of red tape and bureaucratic obstacles are expected pursuant to the implementation of the "Guillotine Law" adopted in February 2005 which will streamline the existing regulations and administrative orders in the commercial sphere. Despite these improvements, Moldovan businesses still operate under less favourable conditions than their peers in neighbouring countries. Government interference in the economy remains high. Corruption remains a serious problem, partly due to the state's continued involvement in the economy. According to Transparency International's 2004 corruption perceptions index Moldova ranks 114th out of 146 countries surveyed, with an overall score of 2.3 (10 being the least corrupt).

Some progress has been achieved in the infrastructure sector, particularly with regards to the telecommunications industry. The National Regulatory Agency for Telecommunications and Information Technologies (ANRTI) has embarked on a comprehensive tariff re-balancing exercise. The sector was fully liberalised in 2004 and a few alternative fixed line operators have emerged. Nevertheless, the state owned Moldtelecom remains undisputedly the main provider of fixed-line telephony. The regulation of interconnection has improved and currently Moldtelecom and the two GSM operators (Moldcell and Voxtel) are obliged to provide interconnection at regulated tariffs for alternative fixed line operators. Initial steps have been undertaken to implement universal services, mainly on a pilot project basis and a few regulatory initiatives related to the creation of a universal service fund have been adopted. Transition progress in the energy sector was less apparent in the past two years. Despite the establishment of the National Energy Regulatory Agency (ANRE), the Government has regularly interfered in the regulatory process, particularly in the power sector, and the once promising reform effort has stalled. The Government's plans to merge ANRE and ANRTI into a single regulator for energy and telecommunications may further compromise transparency and weaken the regulatory process. The privatisation of three of the five electricity distribution companies in 2000 has helped increase tariff collection and service quality, but – as indicated above – the privatisation of the remaining two distribution companies has been postponed. Major challenges also remain in the municipal infrastructure sector. The Chisinau district heating company Termocom is undergoing bankruptcy restructuring and is a major source of fuel energy losses and payment arrears. Moldova's outstanding external energy debt (excluding Transnistria) stood at €211 million at the end of 2004. The water supply and public transport companies in Chisinau have suffered from the municipal council's inability to promote a tariff reform which would ensure financial sustainability.

Progress in the financial sector was mainly confined to the banking sector. The legal framework for banking supervision is mostly in place and soundness indicators are positive, but several weaknesses need to be addressed, including lack of transparency in bank ownership, the application of "fit and proper" standards to significant shareholders and the assessment of credit and market risks. Foreign presence in the Moldovan banking system is still low compared to other countries in the region, with only two foreign banks nominally present in the country (Banca Comerciala Romana, a full subsidiary of the Romanian bank, and Unibank, fully owned by Petrocommerce,

Russia). Banks have substantially increased their lending volume over the last two years, yet domestic credit to the private sector is still only 21 per cent of GDP. Improvements in bank supervision have contributed to enhancing the quality of the loan portfolio, with a share of non-performing loans of 6.8 per cent at the end of 2004. Lending, however, is still restricted to short tenors and specialised products such as mortgages and leases remain underdeveloped. The non-banking financial sector is rudimentary.

Transition Challenges

The key transition challenges for Moldova over the strategy period are as follows:

Establishing fair competition and improving the investment climate – Long term improvements in economic performance require a climate of fair competition for all market participants. In order to achieve this Moldova will need to reduce Government interference in the economy, strengthen regulatory and competition authorities, streamline the legal framework and eliminate informal and administrative barriers and corruption. The EGPRSP and the EU-Moldova Action Plan identify the promotion of competition, legal and regulatory reform, combating corruption and the improvement of the investment climate as necessary pre-conditions to economic growth.

Economic diversification – Moldova's economy is highly dependent on agriculture and the related food and beverages industry. Together they account for more than 33 per cent of GDP, 58 per cent of total exports (mostly to CIS countries) and employ over 40 per cent of the working population. Nonetheless Moldova's agricultural sector is marked by low productivity and low value added. In 2003 gross value added per employee in agriculture was half the average in the economy and 70 per cent lower than in industry. Accordingly the earnings of the agricultural workers and the tax revenues generated in agriculture are relatively small. The EGPRSP advocates achieving long term sustainable economic growth by decreasing the economy's dependency on the agricultural sector and diversifying into sectors with higher value added.

Redressing the balance between Chisinau and the regions – Almost 80 per cent of the population lives outside the capital. Yet, the regions receive less than 20 per cent of foreign investments, account for less than 40 per cent of exports and have wage levels half those in the capital. Local budgets are primarily used to finance current expenditures and rarely have sufficient resources for investment and development. Regionally balanced economic development throughout the country, as advocated by the EGPRSP and the EU-Moldova Action Plan, will require increased investments in regional infrastructure and adequate support for the emergence of MSEs and SMEs in rural areas.

Advancing energy and municipal sector reform – Moldova's energy sector is marked by an almost complete absence of primary energy resources (more than 90 per cent of the primary energy supply is imported) and sizeable foreign debts to suppliers. The main fuel for the country is natural gas (almost 70 per cent of the total primary energy supply). Moldova's energy sector suffers from high energy intensity, obsolete and inefficient equipment, high levels of energy losses, energy tariffs which do not reflect the full cost and regional problems with tariff collection. In the power sector, further regulatory reform will be required to promote fair competition (particularly in cross-

border electricity trade) and efficiency, reinforce the independence of the regulator and ensure full cost-recovery-based tariffs. The remaining state-owned generation assets and distribution companies, whose modernisation will require considerable investment, will need to be privatised. In the thermal energy sector, the district heating systems should be restructured and modernised. The municipal infrastructure sector requires commercialisation, tariff reform and substantial restructuring.

Ensuring debt sustainability – To ensure macroeconomic stability for sustained growth, the Government needs to continue its prudent fiscal policy, tighten monetary policy and gain access to finance from the IMF to facilitate external debt rescheduling where necessary. The EGPRSP and the EU-Moldova Action Plan set debt stabilisation and improved debt management combined with a balanced budgetary-fiscal policy as a medium term objective.

2.3 Access to Capital and Investment Requirements

Moldova has substantial investment and rehabilitation needs both in the public and in the private sector. However, access to both domestic and foreign capital is very limited.

The ability of the sovereign to assume further liabilities remains precarious. Although the debt service obligations are no longer as challenging as in 2001-2, the government still incurs arrears in servicing the external debt and liquidity problems are likely to persist. The Government may incur further indebtedness on concessional terms, primarily from the IMF under the Poverty Reduction and Growth Facility (PRGF) or on IDA terms from the World Bank, conditional on progress in structural reforms.

Net foreign direct investment flows to Moldova increased to €107 million in 2004, up from €60 million in 2003 but the level and quality of FDI inflows remains below the country's long-term needs.

Local commercial banks have considerably increased their lending activities since the last strategy period. The expansion of lending was particularly fast after 2000 and credit to the private sector grew in nominal terms by 45 per cent in 2003 and 25.3 per cent in 2004 increasing the stock of credit to the private sector to 21 per cent of GDP. Nevertheless, access to financing is limited particularly for SMEs and MSEs which form the backbone of Moldova's private sector. Borrowers complain of the short loan tenures which limit their ability to embark on long term investment programmes and the high real interest rates which often make loan financing prohibitively expensive.

3. Strategic Orientations

3.1 Bank's Priorities for the Strategy Period

Moldova faces some unique challenges. Despite improvements over the previous strategy period, it remains the poorest country in Europe. Transnistria continues to be a destabilising factor. Moldova's sovereign debt constraints prevent the Bank from undertaking sovereign infrastructure projects despite urgent rehabilitation and restructuring needs. It also deprives the Bank of one of its main levers in its policy dialogue with the Government. Moldova's well developed banking sector is the Bank's key partner in SME financing. Yet healthy SMEs are constrained by high interest rates charged by the local banks and often postpone expansion plans. The substantial flow of

remittances, if channelled through the local banks, could further strengthen the country's financial system and partly meet its needs for investment finance. Instead it largely fuels consumption, attracts imports and makes exports less competitive as the exchange rate appreciates widening the trade deficit in the process and generating additional inflationary pressures.

Then again, Moldova stands to benefit from a geopolitical shift in the region. Romania's accession to the EU, scheduled for 2007, has increased Moldova's visibility and the recent political changes in Ukraine have resulted in a strengthened European orientation for the Government. These developments entail political and economic policy adjustments which if, implemented successfully, are likely to enhance private sector development.

Accordingly, the Bank's activities over the coming strategy period will support primarily the development of the domestic private sector, including through a co-ordinated policy dialogue with the authorities on improving the investment climate.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Financial Institutions

3.2.1.1 Background

The **banking sector** comprises 16 banks with the five largest banks accounting for over 70 per cent of total banking assets. During the previous strategy period, the sector experienced strong growth and qualitative improvements. During 2004 the assets of the banking sector increased by almost 29.5 per cent in MDL terms, net loans increased by 25.3 per cent and total deposits grew by 38.4 per cent. The product range offered by leading banks has been diversified as they started issuing and servicing debit cards and offering quick money transfer options, on-line banking and incipient housing finance. During recent years a number of positive amendments to the banking legislation were adopted. In particular, minimum capital requirements were gradually increased and regulations have been amended to allow for more efficient lending and treasury management practices. However, weaknesses remain to be addressed, including a lack of transparency in bank ownership, corporate governance and the assessment of credit and market risks.

Micro-finance is a key component in creating sound financial markets in ETC countries. Often it is the first step in transforming MSEs in SMEs. In Moldova, micro-finance is particularly important. In manufacturing, small businesses accounted for 22 per cent of total sales in 2003 and represented 87 per cent of all industrial enterprises. In the trade sector, small businesses are even more important accounting for 32 per cent of total sales in 2003 and 94 per cent of all trading companies. Micro-finance institutions play an important role in providing financing to these small businesses generally deemed unattractive by commercial banks due to the high administration costs they entail and the lack of adequate collateral.

The **non-banking financial sector** remains largely underdeveloped. In April 2005 Parliament adopted a leasing law developed with the Bank's assistance. A dozen or so leasing companies have been established mostly by banks but volume of transactions remains small and mostly confined to car leasing. There are approximately 50 insurance

companies in Moldova. Although the demand for insurance services is growing, the insurance business only accounts for 1 per cent of GDP. The market was consolidated in 2004 when the minimum charter capital for insurance companies was raised but there is scope for further consolidation. The stock market is underdeveloped and marked by low liquidity and insufficient transparency. Not surprisingly its attractiveness to investors is limited.

3.2.1.2 Transition Objectives

The Bank's transition objectives in the financial sector will be to further strengthen the banking sector and financial intermediation, ensure efficient financing of the private sector particularly SMEs and MSEs including in Moldova's regions, develop the use of new financial instruments such as mortgage financing or leasing and support the development of the emergent non-banking financial sector.

3.2.1.3 Operational Priorities

In support of those objectives, the Bank will pursue the following operational priorities:

- The Bank will continue to actively engage its partner banks through the provision of additional SME and MSE credit lines, participation in the Bank's trade facilitation programme (TFP) and the implementation of the MCFF. The Bank will seek to extend its co-operation to new partner banks and to assist in the development and promotion of new financial instruments such as leasing or mortgage financing. On the equity side, the Bank may consider assisting in the privatisation of Banca de Economii, the state owned savings bank and investing in leasing companies and mortgage providers in conjunction with other partners. Where appropriate, the Bank will provide technical assistance, through among others the ETC multi-donor fund, to meet these priorities.
- The Bank will continue to support the development of micro-finance via its involvement in ProCredit and through the extension of its MSE programmes to commercial banks as well as to other, carefully selected, non-bank financial institutions. In order to support the regional development of Moldova's economy, the Bank's micro-finance programmes will include a regional component to ensure appropriate availability of micro-finance outside the capital.
- The Bank will explore opportunities to support the development of the non-banking financial sector through technical assistance from among others the ETC multi-donor fund.

3.2.2 Private Enterprise

3.2.2.1 Background

Agriculture and agro-processing industry is the largest sector of the economy. It generates more than 33 per cent of the country's GDP, employs over 40 per cent of the active population and accounts for 58 per cent per cent of exports. Over the last four years, agro-processing, including fruits and vegetable processing, wine production and vegetable oil production, registered stable growth of approximately 15 per cent annually. Growth in basic agriculture was more modest at 3 to 6 per cent per year.

Land and collective farm privatisation is practically complete. It resulted in a very fragmented structure of land ownership with individuals owning small plots of land which are often completely enclosed and which are not economically viable. A weak investment climate, ad hoc Government interventions in the form of import or export restrictions and the threats of reversals in land privatisation prevent the emergence of restructured and consolidated farms.

Food and agricultural products traditionally dominated Moldovan exports. Moldova remains a net exporter of food and agricultural products mostly to CIS countries. Moldova has no production capacity for – and consequently relies on imports of – inorganic fertilizers, pesticides, additives, veterinary medicines or fuels. Consequently the agricultural sector is vulnerable to exchange rate fluctuations and trade restrictions.

The **manufacturing sector** accounts for 15.7 per cent of GDP and employs 9.4 per cent of the active population. Most of the sector has been privatised (92 per cent). Sixty per cent of the country's industrial production is based in the capital.

Due to chronic underinvestment in the sector, equipment is often worn and technologies obsolete. This in turn increases consumption of energy and raw materials and reduces productivity and competitiveness. Outdated technology also prevents local manufacturers from competing on international markets because they cannot ensure the high production standards and quality consistency required by international clients.

The substantial remittances and the consumption-led growth that ensued have fuelled a **retail** and **property** expansion. Both sectors registered significant growth over recent years especially in the capital city. Existing local supermarket chains have expanded, while international brands such as Metro have entered the market. In addition several shopping malls have appeared and others are currently being built. The retail expansion has occurred in parallel with increased property development as demand for commercial real estate, retail infrastructure and warehouses has risen. The retail and property expansion has had positive repercussions for the **transport, building materials** and **construction** sectors.

3.2.2.2 Transition Objectives

The Bank's transition objectives for the enterprise sector will be to assist enterprises in moving up the value chain and accessing international markets by upgrading their production facilities, assist the diversification and regional development of Moldova's economy, facilitate FDI, improve standards of management, accounting and marketing and enhance transparency and corporate governance.

3.2.2.3 Operational Priorities

The Bank will pursue the following operational priorities:

- The Bank will continue to pursue investment opportunities in all enterprise sectors including without limitation the agro-processing, manufacturing, retail and property sectors. Larger, well performing, companies will be provided with direct financing including through ETC instruments such as the MCFF and DIF. In the agribusiness sector, the Bank will explore investment opportunities among others in export-oriented agro-processing, packaging and retail. In the property sector, the Bank will look for opportunities to support, directly, offices, logistics and retail infrastructure

projects as well as, indirectly through mortgage finance facilities, residential development.

- The Bank will implement a structured marketing approach. In order to promote the diversification and regional development of Moldova's economy, the Bank will mainly direct its marketing efforts to companies active in non-food related sectors and located in the regions.
- The Bank will facilitate FDI either by investing alongside foreign strategic investors or by assisting the development of local companies which in due course may attract foreign investment.
- The Bank will continue to work with the Government and donors to establish a warehouse receipt system which will allow the Bank to provide working capital to the agribusiness sector and improve transparency of commodity transactions.
- The Bank will continue to provide non-financial support to private enterprises through its TAM and BAS programmes to improve local management skills, support international certification and assist with business planning and restructuring.

3.2.3 Infrastructure

3.2.3.1 Background

Moldova's infrastructure sector suffers from chronic underinvestment, deferred maintenance and a weak regulatory environment. The continued deterioration of basic infrastructure hinders genuine economic recovery, jeopardises the country's competitiveness and reduces the likelihood of attracting quality foreign investors. Although deteriorating infrastructure is generalised throughout Moldova, it is particularly acute in rural regions.

As indicated in section 2.2 above, Moldova's **energy sector** is marked by an almost complete absence of primary energy resources and a low hydroelectrical potential. The country is highly dependent on energy imports mainly from Russia and Ukraine with 90 per cent of energy consumed being imported. Over the last 15 years natural gas has replaced coal as the main fuel and now constitutes 75 per cent of total primary energy supplies.

In the power sector, further regulatory reform will be required to promote competition and ensure transparency of the market, reinforce the independence of the regulator and ensure full cost-recovery-based tariffs. The remaining state-owned generation assets and distribution companies will need to be privatised. The EU-Moldova Action Plan and the Energy Community of Southeast Europe provide Moldova with a framework to achieve these objectives.

Moldova's strong dependence on imported energy resources makes the use of local sources, including renewables, a necessity. To date, however, the practical implementation possibilities of renewable energy projects remain weak due to limited regulatory support and insufficient capital resources.

Transport is an essential component for sustainable growth. Albeit a landlocked country, with only limited access to the Danube, Moldova could potentially act as a gateway between CIS countries and, following Romania's accession in 2007, the EU.

To date, however, no concerted effort has been made to address the needs in line with the changing trade patterns. The deterioration of transport infrastructure over the last 15 years has furthermore significantly reduced the quality of transportation services and contributed to rising costs due to the increase in operational expenses.

The legal, regulatory and financial environment for investments in support of **municipal infrastructure** investments remains problematic. Despite the very poor condition of municipal infrastructure, especially in the water and wastewater network, and poor reliability in basic services, the levels of investment are constrained by the lack of revenue and inadequate cash flow at the level of operating companies. In some important markets such as Chisinau, there is continuing reluctance to raise tariffs to the levels which can cover operating costs let alone new investment. The poor service in turn undermines tariff-collection discipline and the lack of efficient and workable legal and regulatory mechanisms prohibits utility companies from taking action against non-payers. Privatisation or management contracts for the utility companies might be an option for their successful turn around. However these first require a strong commitment from and a favourable environment to be created by the central and local authorities of Moldova.

An efficient **information and communication technology (ICT) infrastructure** can substantially enhance economic growth. The telecom sector was fully liberalised in line with the requirements of the WTO "Reference Paper" on telecommunications. Around 40 licenses were issued in 2004 to private fixed-line service providers and a few companies have started operations. However, the state-owned Moldtelecom is expected to remain – at least for the medium term – the dominant provider of local, long distance and international fixed-line telephony as well as voice over internet services. Attempts to privatise Moldtelecom in 2003 failed due to lack of interest from investors. The EGPRSP sets privatisation of Moldtelecom as one of its objectives but no new date has so far been set. Mobile telephony services have expanded rapidly over the past years. Voxel and Moldcell, the two providers, have approximately 500,000 and 400,000 customers respectively.

There is some competition in the internet service provision, even though there is very little diffusion of such services and usage varies considerably across the different sectors of the economy. Moldova's multilingual labour pool and low labour costs could make Moldova a potentially attractive location for outsourcing services and call-centres. This, however, will require further upgrading of the telecommunication infrastructure and a commitment to IT education.

3.2.3.2 Transition Objectives

The Bank's transition objectives for the infrastructure sector will be to assist the Government in the transparent privatisation of key state-owned infrastructure assets, support the emergence of a robust regulatory framework, support the regional development of all infrastructure sectors, support private investors and generally improve standards of integrity, transparency and corporate governance in all sectors but particularly in the energy sector.

3.2.3.3 Operational Priorities

Given the severe sovereign debt capacity constraints, the general lack of interest from investors and the weak regulatory environment, investment opportunities for the Bank

in the infrastructure sector over the next strategy period are expected to be scarce and challenging. The Bank will primarily focus on private sector opportunities and will pursue, in close consultation with its partners, the following operational priorities:

- In the **energy sector**, the Bank will endeavour to identify energy saving measures in its projects through the Sustainable Energy Programme (SEP).¹ The Bank will consider providing credit lines and associated technical assistance through local banks for energy efficiency improvements for industrial as well as for residential end-users. In the **transport sector**, the recent acquisition by Azpetrol of the Giurgiulesti Oil Terminal may offer scope to develop associated and viable investment projects which the Bank may finance. In the **telecom sector**, the Bank will consider providing loan and equity financing to private ICT operators, including mobile telephony and cable TV.
- The Bank will actively seek opportunities to participate alongside suitable strategic investors in the privatisation of key assets in the **energy** and **telecom sectors**. The Bank's participation will, however, be subject to transparent privatisation processes and the existence of a satisfactory regulatory framework.
- The Bank's continued involvement in the **municipal sector** will be contingent on surmounting the ongoing obstacles to the successful implementation of the Bank's current municipal water project in Chisinau. Approval of tariff increases to cost-recovery level would facilitate consideration of follow-on projects in Chisinau, and elsewhere with other smaller and poorer cities.
- The Bank has emphasized its commitment to smaller infrastructure projects under its ETC initiative and resources have been identified (particularly from the EU) to co-finance projects in poorer regions with grant funds recognising affordability constraints.

4. Other IFIs, Multilateral and Bilateral Donors

4.1 IFI and Donor Co-operation

The co-operation among the IFIs and the donor community in Moldova has been good. The Bank regularly exchanges views and information about ongoing and planned activities with the IMF, WB, IFC, UNDP and BSTDB. The Bank actively engages with the donor community through the monthly donor meetings. In addition, the Bank's Resident Office has had bilateral discussions with among others TACIS, USAID, DFID, SECO, SIDA, SDC and DEG.

The main focus of donor assistance is civil society, rule of law, SME development, trafficking, Transnistria and statistics. The EGPRSP, adopted by the government in May 2004, provides the overarching policy framework for the sustainable development of

¹ In 2005 the Sustainable Energy Programme (SEP) was launched as part of the ETC Initiative. The programme aims to support the Bank's existing or prospective clients to identify and to facilitate the development of sustainable energy projects in ETC countries. The SEP comprises of two services: (a) free energy audits to assist industrial and commercial clients in investigating cost effective energy efficiency measures and bankable investment opportunities; and (b) the Clean Development Mechanism (CDM) Project Support Facility (PSF) which assists project sponsors in developing emissions reduction projects and subsequently monetising them through the sale of Carbon Credits.

Moldova and provides a good platform for enhanced coordination among Moldova, the IFIs and the donors.

For an overview of the Bank's technical co-operation programme and the donors who have contributed to it, please refer to Annex 6.

4.2 International Monetary Fund (IMF)

Moldova joined the IMF in August 1992. Due to early transition successes, Moldova initially had access to the IMF Stand-by Agreement Facility conceived for middle-income countries. As the economic conditions worsened, Moldova was granted access to IMF's concessional PRGF. The last IMF programme was launched under the PRGF in 2000 for the duration of 3 years and for an amount equivalent to SDR110.88 million (approximately €18 million on 21 December 2000). Three tranches, totalling nearly €31.5 million were disbursed in December 2000, February 2001 and August 2002. In 2002, Moldova went off track with the programme and the IMF suspended payments. The programme expired at the end of 2003 and was not renewed. The suspension of the IMF programme has also impeded negotiations with the Paris Club on a rescheduling of Moldova's bilateral debt.

Although the last IMF Article IV Executive Board Consultation in February 2005 was cautiously optimistic, a new IMF programme is unlikely before the end of 2005. The IMF maintains a close policy dialogue on the reform priorities with the authorities. The IMF is assisting the authorities to effectively implement a credible and well articulated reform programme in line with the EGPRSP and the EU-Moldova Action Plan.

4.3 World Bank Group

Moldova joined the **World Bank** (WB) in 1992 and the International Development Association (IDA) in 1994. Moldova became eligible for concessional credits from IDA in 1997. Since joining the World Bank, Moldova has received financing for 42 operations, including 4 adjustment IBRD loans and IDA credits, with a total commitment of \$592 million of which \$413 million have so far been disbursed. At present there are 11 operations under implementation, with a net commitment of \$148 million of which 62% is undisbursed. Three other operations are under preparation (in education, private sector development and the rural sector) for a total amount of \$30 million. Initial lending focused on adjustment support, building a private sector in both agriculture and manufacturing and improving the economic and financial management of the energy sector.

Disbursements under the WB's Structural Adjustment Credit III (SAC III) for an amount equivalent to \$20 million were cancelled in December 2003 due to non-fulfilment of conditionalities. The programme was not renewed when it expired in 2003. The aim of the SAC III programme was to support the Government's reforms programme aimed at creating conditions for sustainable growth and improving living standards.

The current Country Assistance Strategy (CAS) of the WB for Moldova was adopted in December 2004 and covers 2005-2008. It is aligned with the EGPRSP and its overall objective is to contribute to poverty alleviation. Under the CAS, new lending will total \$90 million of which about 50% would be provided in grants for fiscal year 2006.

Budget support would be contingent, among others, on a solid track record of improvements in the business environment and public sector governance.

Since Moldova became a member in 1995, the **International Finance Corporation** (IFC) has committed \$57 million of its own funds and arranged \$25 million in syndications for supporting the power, telecommunications, agribusiness, SMEs, and the financial sectors. In addition, IFC has also supported technical assistance projects in banking, tourism, wineries, food processing, and leather industries. Going forward, IFC will maintain its support in helping develop private enterprises, by providing long-term funding through local banks and through assistance for attracting foreign strategic investors.

IFC's current strategy for Moldova aims to support the development of private enterprises, especially by providing them with long term funding through local banks and to strengthen the Moldovan banking sector. IFC will also pursue opportunities to support infrastructure development, which is vital for private sector growth and poverty alleviation in Moldova.

Moldova has been a member of the **Multilateral Investment Guarantee Agency** (MIGA) since 1993. MIGA guarantees facilitated approximately \$63.7 million of foreign direct investment (FDI) in the power, financial and real estate sectors. It has also been involved in mediating disputes (in the power sector) and provided technical assistance to formulate and implement strategies for attracting FDI, with advice and tailored assistance to public and private organizations in image-building, sector-targeting, outreach and information dissemination. MIGA's online information service has 153 documents for Moldova pertaining to investment opportunities and other related legal and regulatory issues.

4.4 European Union (EU)

The EU plays an increasingly important role in supporting the transition of Moldova. In March 2005 the European Council appointed a Special Representative for Moldova to contribute to the peaceful settlement of the conflict surrounding the secessionist region of Transnistria. The opening of an EU Delegation in Chisinau, announced for the second half of 2005, responds to Moldova's requests for closer ties with the EU and will no doubt facilitate the implementation of EU assisted programmes in Moldova.

EU activities in Moldova are framed within the Partnership and Cooperation Agreement and the European Neighbourhood Policy (ENP). The EU-Moldova Action Plan, adopted by the EU and Moldova in February 2005, sets forth the strategic objectives of the ENP cooperation between Moldova and the EU for the next three years. The EU-Moldova Action Plan covers the following priorities: democracy and rule of law, economic development and trade, justice, liberty and security issues and sector specific issues. Implementation of the EU-Moldova Action Plan will advance the approximation of Moldovan legislation, norms and standards to those of the EU and will support Moldova's ambition of further integration into European economic and social structures.

Since 1991 the EU has provided €253 million in technical assistance. This includes among others assistance provided under TACIS and the Food Security Programme, humanitarian assistance and macro-financial aid through balance of payments loans and

grants. EU macro-financial assistance is currently put on hold following the suspension of the IMF programme and will expire at the end of 2005.

4.5 European Investment Bank (EIB)

In December 2003, the European Council granted the EIB a mandate for financing selected projects in Russia as well as, subject to certain conditions, Ukraine, Moldova and Belarus, for an amount of €500 million in the areas of environment and transport, telecommunications and energy infrastructure on priority TEN axes with a cross-border aspect for EU Member States. The final EU Council Decision rendering this mandate effective is expected in 2005.

4.6 United Nations (UN)

Moldova became member of the United Nations in 1992. Since that time, various UN Agencies have launched their programmes in the country in order to assist it. The United National Development Programme (UNDP) is the main body for coordinating the United Nations development work. It provides policy advice and helps build institutional and human capacity that generates equitable and sustainable growth. UNDP has committed \$20.5 million to Moldova between 1993 and 2004. For 2005, UNDP plans to commit another \$6.7 million. The UNDP programme in Moldova is organized around two major themes: governance and sustainable livelihoods. Specific programme interventions are aimed, inter alia, at strengthening local governance, facilitating the judicial reform, promoting human rights and gender equality, protecting the environment, improving the external debt management and facilitating the development of tourism in the country.

4.7 Black Sea Trade and Development Bank (BSTDB)

Moldova is a founding member of the BSTDB which started its operations in 1999. The BSTDB has one active operation in Moldova: a \$3.19 million guarantee facility to ProCredit. The BSTDB's current country strategy for Moldova covers 2005-2006 and focuses primarily on the private sector particularly financial intermediation.

4.8 Bilateral Donors

The United States of America is the single largest bilateral donor in Moldova. Since 1993, the **United States Agency for International Development (USAID)** has provided more than \$425 million in technical assistance. USAID's development assistance programme in Moldova focuses on a limited number of priority objectives established in its 2001-2006 Moldova Strategic Plan including: private enterprise development (primarily support for private agriculture, micro-enterprises and small business); strengthening the capacity of local government and independent community organizations to tangibly address local community priorities; promoting health programmes that address the most critical public health issues in Moldova, such as tuberculosis, HIV/AIDS and viral hepatitis B&C; and addressing the problem of trafficking in women through activities focused specifically on the economic roots of trafficking. Since 1997 the **United States Department of Agriculture (USDA)** has provided more than \$32 million in humanitarian aid and technical assistance food aid programmes to Moldova. Over two million Moldovans have benefited from USDA

programmes. Food aid development projects have focused on rehabilitation of the agricultural sector, farmer training, small scale infrastructure development, plus health and nutrition education and training. Humanitarian assistance has been provided to vulnerable families, orphanages, hospitals and pensioners. For 2005, US Government agencies plan to provide an aggregate \$21.7 million to finance democracy programmes (\$5.8 million), economic and social reform (\$6.6 million), security and law enforcement (\$3.4 million) and humanitarian assistance (\$0.4 million).

Swedish support to Moldova started in 1996, through the appointment of an advisor to the Government within the framework of a UNDP-administered democracy-project. From 1998 onwards, Swedish support to Moldova has increased. Between 1996 and 2003, **Swedish International Development Cooperation Agency (SIDA)** has provided approximately €19 million. SIDA's strategy for 2004-2006 focuses on democratic governance, debt rescheduling, sustainable development and economic growth to alleviate poverty, prevention of social exclusion and promotion of public health. Sweden has a flexible budget system. Funds are allocated according to need and recipient country capacity. For 2004-2006 SIDA's objective is to increase the volume of cooperation to an annual amount of up to €10 million.

The United Kingdom's **Department for International Development (DFID)** has been active in Moldova since 1991 and has provided up to £14 million in technical assistance. The annual technical assistance continually increased during the last few years, building up from £1 million in 1999 to around £2.3 million per annum in 2004. The current programme covers the period 2004 to 2007 and focuses on improving governance and the institutional environment for poverty reduction, promoting pro-poor sustainable growth and conflict resolution and peace building.

To date Germany's **KfW Entwicklungsbank** has committed to Moldova an aggregate amount of €10.22 million consisting of a €2 million financing of agro-service stations in the sugar sector, a €3.6 million credit-line to Procredit and €4.6 million investment in social infrastructure. In 2003, the cooperation was discontinued but Germany indicated that it might resume its cooperation with Moldova at a lower level.

Switzerland has been active in Moldova since 2000, providing assistance especially in the way of humanitarian aid. In 2004 the **Swiss Agency for Development and Cooperation (SDC)** strengthened its support of the transition process mainly in economic and social sectors. The **Swiss State Secretariat for Economic Affairs (SECO)** funded the Bank's technical assistance project on mortgage reform.

The Netherlands' technical assistance budget amounts to €3.6 million. Its main goals are to contribute to the development of a market economy, the strengthening of the competitiveness and modernisation of private enterprises and the development of sustainable processes of production in industrial and agricultural sectors. As of 2005 Dutch-Moldovan joint ventures could qualify for grants under the Netherlands' Programme for Cooperation with Emerging Markets (which has an annual budget of €1 million for 42 countries).

Denmark has been active in Moldova since 1998 in particular on environmental issues and NGOs support. The Danish Environmental Assistance to Eastern Europe (DANCEE) has provided approximately €5 million to Moldova in technical assistance to date mainly to improve water management and to implement the Aarhus Convention. Although Denmark is no longer directly engaged in Moldova, Moldova has been

included in a Regional Anti-Human Trafficking Programme (together with Ukraine and Belarus) funded by Denmark. The programme is due to start in October 2005 and is expected to last 3 years with a total budget of €3.5 million.

Norway has been supporting the social, economic and democratic development of the Republic of Moldova since 1994. To date Norway has provided an estimated €6.1 million. Norway has recently increased its assistance from €1 million in 2004 to €2.2 million in 2005. Norway's assistance focuses primarily on improving border control, withdrawing or destroying ammunition in Transnistria, developing statistics, improving medical facilities, assisting disabled children and fighting against tuberculosis.